CHAPTER 11

Recent Lessons Learned and Current Trends

The period 2006–2008 may go down in history as one that exemplified all that was wrong with Wall Street, Main Street, and global financial systems. In other words, just when you think you've seen it all, a tsunami strikes, and worlds and lives change in an instant. Fingers may be pointing for many years to come about who did what to whom and when; the subprime crisis and the subsequent credit freeze can be attributed to the excessive greed exhibited by all parties, including hedge funds, hedge fund investors, and the banking and mortgage industry.

Although some hedge fund investors may point to hedge funds that "took advantage" of their investors during this period, investors were more than satisfied with superior returns but did not ask "Why is my manager doing so much better than others." Alternatively, a better outcome may have been achieved by investors who believed that everything trades at a price for a reason and asked why the actual returns or projected returns were higher than historic industry averages.

A key principle of hedge fund investing is that hedge fund risk is different from traditional asset management risk because of

- The use of leverage
- The ability of the manager to short
- Reduced transparency
- The cultural background of managers to assume greater or different risk

However, as most investors understand, to make money you have to take some risk. Market-neutral managers who profess to make money consistently may not really be market neutral. There must be some risk inherent in the portfolio other than "zero" market exposure.

WHERE THE RISK IS FOUND

The key to understanding return is to understand the actual risk embedded in the hedge fund portfolio. Many equity and fixed-income managers claim to be ‘‘market neutral.’’ Ask these professionals what happened in August 2007 or August 2008. Market neutral is supposed to offer no market exposure, but these funds suffered along with pretty much every other fund.

A risk management system does not eliminate risk; it should present the risk and reward in the portfolio in a fair and equal way. Even though the risk management system may present the ‘‘what if’’ in different scenarios, the quantitative portion represents only part of the analysis. The ‘‘gut check’’ lies in the practical understanding of what may happen in the market meltdown or doomsday scenario. The real purpose of the risk system turns out to be surprise avoidance, and only the manager can tell whether it really works.

Many investors believe that the market experiences a 10 standard deviation event (something that is extraordinary such as the collapse of an industry, a large company, or an economy) every four years, and that when this occurs fixed-income strategies become particularly vulnerable to this volatility. We believe that the markets have averaged a 10 standard deviation event nearly every year, starting in 1997 with the ‘‘Asian Flu’’ and continuing in 1998 with the LTCM blowup, in 1999 with the Brazilian crisis, in 2005 with the General Motors–Kirk Kerkorian chaos, and in 2008 with the bankruptcies of Bear Stearns and subsequently of Lehman Brothers.

Risk management cannot predict the next event, and the resulting output may be a flawed result of stress testing. One fact is clear: old-fashioned, well-thought-through intuition may be best, but it is far removed from the quantitative and qualitative analysis needed to make investment decisions.

Noncorrelated Investments

At the end of the day, hedge fund investors who have invested because hedge funds are ‘‘not correlated’’ to the capital markets must understand that their strategies may in reality be correlated to others and must attempt to understand strategies in different market scenarios. As we witnessed in 2007–2008, while nervous investors rushed to buy U.S. Treasuries (the standard flight to quality reaction in a downturn), bond spreads on agency and nonagency mortgage-backed securities (MBS) widened and fell in price because of the fear of the spread of delinquencies and defaults to these bonds. Even though the risk models may have indicated that Treasuries and agency MBS would go in the same direction, in fact, they did not. The widening of spread occurred in all sectors of the fixed-income markets—MBS, high-yield bonds, and distressed bonds—as well as in many sectors of equities, demonstrating the positive correlation of many sectors and disappointing both hedge fund managers and investors.

In periods of market stress, market risk and credit risk are interrelated, and stress testing may not detect this. In periods of stress, the markets often act irrationally. Many investors in hedge funds use consultants as a barrier for protection during meltdown periods. Investors are always looking to place the blame on someone else's shoulders. Managers are always quick to respond that the market is irrational and declare, "Our analysis is correct."

Successful hedge funds and fund of funds have strict written policies and procedures to deal with market or fund dislocation events; this often requires the manager to stick to stringent but flexible investment parameters. On the other hand, managers who lack written policies are generally the ones who encounter difficulties in tumultuous markets and deliver disastrous results to their investors.

Transparency

While obtaining hedge fund position transparency is always challenging, one of the best, if limited, public sources of information for equity position is quarterly 13-F filings that managers make based on Securities and Exchange Commission (SEC) requirements. The SEC requires that investment managers who manage more then $100 million file quarterly reports of the public securities it owns.[1] The data is limited, because it shows positions as of quarter end and is not a reflection of current activity. While the results will vary from period to period, generally the most commonly bought stocks outperform, while the most commonly sold stocks underperform. Market capitalization is important as well, with small-cap and mid-cap stocks having the greatest price volatility with concentration of hedge fund ownership.

The key issue for the hedge fund investor is to understand the concentration risk and its resulting impact on the liquidity of the individual positions "when the music stops." It adds another dimension to the risk—or rather the reality—of hedge fund liquidity. Sectors that hedge funds are buying or selling may have an impact on price performance and liquidity.

Periods of market stress also reveal weakness in hedge fund managers' back offices. Even though all hedge funds and fund of funds are quick to tell investors and potential investors that they have an annual audit performed by a major accounting firm, this action is completed just once a year. The increasing presence of institutional investors including large pension funds has altered the way hedge fund assets are managed and reported. High net worth investors and family offices are not subject to the same strict reporting requirements, but they want to receive the same level of reporting. Back-office problems often indicate weakness on the part of managers, who will unquestionably come under pressure in periods of market stress. A once-a-year audit, while fine for the government and the taxman, is not enough for any investor. Information needs to flow with regularity.

DELEVERAGE ISSUES

One of the centerpieces of hedge fund investing is buying when others are selling. As a result, hedge funds armed with leverage can buy securities that are being dumped by others, price the securities at a discount, and hold on to them for a long time in expectation of substantially higher future prices.

In 2007, commercial banks were saddled with hundreds of billions of dollars of unsold leveraged buyout (LBO) positions. The hedge fund community could not buy them, because prime brokers demanded higher haircuts on collateral and the accountants required greater transparency regarding pricing. The GPS is certainly a wonderful and practical invention, but still we ask, what happens when the battery dies? In the hedge fund industry, it's important to be able to read a road map as well as use the electronics device, but there is no substitute for good, independent judgment.

New Leverage Rules

As the hedge fund industry matures, reacts, and transforms itself in the aftermath of the 2007–2008 meltdown of the financial services industry and hedge fund industry, several trends are taking shape. The first is the changing face of hedge funds brought about by the actions of the Federal Reserve Board and the U.S. Treasury Department in a 10-day period during September 2008. Reacting to the deteriorating credit situation in the U.S. and global markets and the reduction in or freezing of the global capital and financial systems, Treasury Secretary Henry Paulson moved to seize Fannie Mae and Freddie Mac in an effort to reduce worldwide systemic risk. To prevent a run on the banks, he strongly recommended that Merrill Lynch, Morgan Stanley, Goldman Sachs, and Lehman Brothers seek merger partners within the commercial banking industry and that AIG raise $85 billion in new capital.

The story of what happened is no secret and probably does not need to be repeated. But for those who missed it, Lehman went bankrupt and Merrill Lynch was sold in a fire sale to Bank of America. Goldman raised money from Warren Buffett, and Morgan Stanley sold a chunk of its business to the Japanese company Mitsubishi UFJ Financial Group, Inc. Then under the cover of darkness, Paulson, under the direction of President George W. Bush, forced all of the large financial institutions to take billions of dollars in taxpayer money in return for preferred stock positions in the underlying companies in an effort to restore stability to the financial system. Needless to say, by June 2009 things were starting to right themselves. Both AIG and Citibank had gone to the trough again, and the others seemed to be holding onto whatever respect they had left in order to get out from under the federal government's thumb.

History will judge the "shock and awe" actions of President Bush and Secretary Paulson, but one fact is clear: the Feds wanted greater control of both the financial services industry and the hedge fund industry. It all happened during that 10-day period. The prime brokers, the purveyors of unbridled leverage, are now controlled by federal examiners. Leverage may not be gone, but it has been reduced. The Fed and the SEC also demonstrated that they would impose restrictions on shorting stocks to "maintain market liquidity."

While many shook their heads in disbelief that a far-right, free-market U.S. president could move to the left so quickly, several other things became quite clear. First, the hedge fund industry is no longer the bad guy on the block but rather one of many bullies taking advantage of the weak. Second, the days of unbridled leverage are over. Third, Darwin is alive and well on Wall Street, Main Street, and any other place that matters; only the strongest survive.

Despite the strong blow delivered by the Federal Reserve, inflows of new capital into hedge funds and fund of funds remain at high levels as many new entrants, including large pension plans, foundations, and endowments, are entering the alternative investment industry for the first time. Furthermore, the flawed calculations and the strategies that performed poorly have caused allocators and investors to review the entire due diligence and research process and are now looking to move money (whatever is left) to new funds.

FUND OF FUNDS FIRST

For many new first-time hedge fund market participants, investing in fund of funds will be the likely first choice. However, with the increased need for more customization of portfolios to meet specific asset allocations and lower fee structures, institutional investors with larger portfolios, probably in excess of $500 million, will likely evaluate options to bring their investment functions in-house. As this occurs, there will be a migration away from fund of funds to single-strategy investing. Benchmarks will be evaluated to compare peer group performance, with less reliance on industry-recognized reporting sources (e.g., the HFRI or Lipper indexes) in favor of comparisons to other pension plans or endowments, when such data is available.

Institutional investors will reexamine due diligence procedures to ensure that the existing policies and procedures have been reviewed and changed with the aim of reducing stress due to market forces. Institutional investors are likely to keep on preferring larger fund of funds and hedge funds over smaller managers. The multibillion-dollar fund of funds are expected to grow even more, and hedge fund sizes will grow to accommodate the large inflows of capital from institutional investors. However, given the poor returns of the 2007–2008 period and the redundancy of positions taken by many fund of funds and hedge funds, many investors are now moving toward smaller fund of funds in the range of $500 million to $2 billion to take advantage of niche strategies such as technology, emerging markets, or green or socially responsible funds. Smaller funds are more adept at identifying underlying niche managers and are more flexible, having smaller pools of capital to commit.

Both smaller fund of funds and smaller hedge funds will remain under pressure for performance returns but will gain a greater share of growing assets in an effort to compete with the large organizations. Contrary to popular thinking, performance may not necessarily be the primary barometer; size will continue to rule, and performance will follow. Despite being outperformaned by smaller funds, large management companies will continue to offer institutions greater comfort through their sheer bulk.

Portfolio Valuation

Valuation of securities will remain a key issue. As hedge funds have migrated toward more private equity, less liquid positions, in part funded with the LBO binge of 2005–2007, investors want greater transparency and more liquid positions. In the wake of the subprime debacle, investors in opaque strategies such as ABS and CDOs that seek to capitalize on the dislocation want to feel confident that the manager will provide a high level of clarity regarding the implementation of the strategy.

Because of the blurring of the lines between many strategies with lessened liquidity and increased private equity positions, hedge fund managers have lengthened redemption periods. While this may be an effective tool for the hedge fund manager and may reduce the outflows of capital, it presents a challenge for fund of funds that must find alternatives for funding redemptions of the underlying managers.

New Rules, New Products

Don't be surprised by future surprises. What once was marked ''made in America'' with subprime, Alt A, mezzanine financing, and an even longer laundry list, is now held by investors all over the globe. The crisis may have reached its peak, but investors must exercise a higher degree of due diligence in reviewing managers to anticipate what the next product or sector to cause global dislocation may be.

Strategies based on 130/30 will continue to grow in popularity as institutional investors resist higher hedge fees and look for cheaper alternatives that still provide greater transparency. It will take a period of a few years to measure the success of returns, not the growth of assets, in this arena.

Wall Street distribution of hedge funds will be limited and will come under pressure. The old business model of capital introduction by the prime broker has lost several key players, and hedge fund managers and specialized fund of funds will have to rely on internal marketing teams to raise assets.

Tighter regulation of hedge funds by global regulators including the SEC and the United Kingdom's Financial Services Authority, or FSA, will continue as the institutional client base grows. As more high net worth investors step up investments into more retail-oriented product, the test for high minimum levels of assets can be expected to become more stringent.

Thank You Bear and Lehman

In the wake of the failure of Bear Stearns and Lehman Brothers and the weakened balance sheets of investment banks, investor preference for bank balance sheets will be increased. Investors may feel less comfortable with the limited number of investment banks as derivative counterparties or providers of leverage and will seek hedge funds and fund of funds that use commercial banks for financing or as prime brokers for nonequity transactions. There has been a sea change in the environment for credit. Credit providers are aiming for a greater understanding of credit, particularly in the fixed-income markets. Leveraged strategies will be under increased scrutiny, with credit providers requiring greater liquidity and higher levels of margin. Repo-financed strategies may not be able to achieve the same level of historic returns as in past markets, given the lower levels of leverage and financing. Strategies that depend on short-term funding will be subjected to the increasing risk that the leverage provider will indiscriminately change the haircut and the term of financing.

At the same time, investors will again call for greater transparency, and prime brokers will continue to provide a greater flow of information to clients and hedge fund investors in the respective funds. Larger institutional investors and large fund of funds will demand separate accounts to achieve increased transparency and increased risk management. Heightened levels of due diligence will be performed by both investors and credit providers to avoid potential landmines and reduce the impact of systemic risk in other parts of the balance sheet.

Fund of funds will become larger. These firms must have an extensive infrastructure to build a scalable business and to be able to accommodate large inflows of new investment dollars.

Government regulators will exercise increased oversight. As their actions during September 2008 indicate, the regulators feel that the hedge fund industry had become too large, with its $2 trillion of equity and $10 trillion of market exposure. These figures do not include the potential trillions of dollars of off-sheet derivative exposure.

Will hedge fund fees of 2 and 20 percent at $200 million of assets work at $20 billion? Probably not. Does the manager have the same incentive to produce the same quality of results as the smaller shop? Are fund of funds that are now asset-gathering machines still concerned about producing results? The jury is out, but many believe that asset gathering is more important to management then true asset management.

THE END OF AN ERA

The golden age of investment banking is over. Fewer transactions reduce opportunities for many strategies but create new ones for flexible managers. The number of investment banks has contracted, and with greater Fed oversight and desire for lower leverage, the influence of the commercial banking industry will decrease, resulting in a lower risk profile and less compulsion to do deals for the sake of doing deals. To capitalize on the new opportunities, many hedge funds will need larger infrastructures.

Do investors understand the liquidity mismatch present in both hedge funds and fund of funds? Managers have longer-term positions and redemption liabilities that can change like the weather. Redemptions in 1998 and in 2007, even in good funds, amounted to investors rebalancing and seeking higher liquidity levels.

The question is why do many pensions go from allocating virtually nothing to 5 percent of their assets to hedge funds? Is it because of the lack of depth and expertise shown by the consultant while some large pensions have allocations similar to those of the successful college endowments?

One of the most talked-about investor classes that no one really knows anything about but everyone knows everything about is sovereign wealth funds (SWFs). Because of the large flows of capital resulting from the recycling of petrodollars and the growth in what used to be emerging markets, these investment entities have unprecedented levels of capital to put to work. Although many SWFs have become active in the capital markets by recapitalizing global financial institutions or purchases in the mergers and acquisitions (M&A) market, with total assets estimated to exceed $3 trillion and expected to increase substantially over the next five years, many estimate that their assets will flow directly into hedge fund coffers.

The Sovereign Wealth Funds

When hedge funds stop being front-page news, the next focus will be SWFs. Many of these funds have been around for many years, but with emerging economies such as Russia and China no longer emerging, and oil exporters Kuwait and Saudi Arabia seeing one-way flows of capital into their countries, the deployment of SWF capital will impact the capital markets globally as well as hedge fund strategies. We have already seen several high-visibility investments into U.S. and other global commercial banks with new capital to offset the decline of equity ratios concomitant with the write-offs due to poor commercial loan underwriting and exposure to subprime assets.

One of the largest and oldest SWFs is the Abu Dhabi Investment Authority (ADIA) established in 1976. ADIA has been investing globally in a wide range of countries and industries and owns large equity positions in Citigroup, Toll Brothers, and Apollo Management, to mention just a few. In spite of the large influence that it can wield, ADIA was rebuffed in its attempted purchase of U.S. ports.

Disclosure ranges from complete disclosure by Norway's governmental pension fund to required SEC filings of 13F equity holdings by many SWFs to low disclosure of holdings by many others. Because the investment objective varies among the various funds, many are oriented to absolute returns and positioned to achieve a higher risk profile. Although many invest in highly liquid securities, many SWFs invest in higher-return instruments. As a result, hedge funds, real estate, and private equity have experienced substantial inflows, with more expected.

SWFs Are BIG

According to a J.P. Morgan report dated May 22, 2008, SWFs currently own $270 to $340 billion in alternatives, or 6.8 to 7.5 percent of total alternatives, with half in private equity. Although much of investment mandate is managed internally by SWFs, each fund externally allocates substantial portions of the asset pools, particularly in the hedge fund sector. J.P. Morgan estimates that "roughly 60 percent of SWFs use external managers, with about half of SWF assets managed externally."[2]

In evaluating the impact of SWFs on hedge funds, the breakdown indicates that SWFs probably constitute about $150 billion of total hedge fund assets. While the amount is not large and will be growing, the conclusion is that the capital flows will be directed to the large managers that can accept large balances. Capital will also be directed to specific strategies that the SWFs want to have direct exposure to rather than to fund of funds with more of a multi-strategy investment approach.

As part of the due diligence process for hedge fund investors, it is important to know and understand what the total investor base profile of the hedge fund is, not just to know names but to understand and project what the investment objectives of the other investors may be. Given the volatility of the capital markets, highly fluctuating currencies, and ever-shifting geopolitical climates, investor funds may be sensitive to market as well as nonmarket factors, and well-informed investors should be prepared, along with managers, for sudden and unpredictable movements of capital. More investment funds will continue to be attracted to hedge funds by SWFs, especially in light of the decline of asset values in the developed world.