Hedge of darkness

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Their performance is shocking - down nearly 10 per cent so far this year, according to the HFRX daily index. Requests for redemptions, which investors have just lobbed in for the fourth quarter, could be horribly high. This, in turn, could lead to hedge fund liquidations that could surpass the previous high in 2005, when roughly 10 per cent of funds closed up shop. Leverage is hard to get, limiting funds' ability to generate absolute returns. With the restriction on short selling financial stocks, regulators have also torpedoed an important hedging tool, albeit - one hopes - on a temporary basis. Oh, and if you have been using Lehman Brothers as prime broker, you might have a job trying to figure out what the bust investment bank did with your collateral, as Olivant has discovered. Could it get any worse?

Out of all these, redemptions are probably the most pernicious, because they could cripple good hedge funds as well as ailing ones. Institutional investors in hedge funds have their own clients' anxieties to assuage - a vicious new twist. Losses, meanwhile, will kill performance fees. That need not sink hedge funds, assuming they were not using those fees to cover run-of-the-mill expenses. But losses encourage funds to liquidate, since managers may figure the long haul back to their high-water marks (the fund's previous high, which it has to reclaim before it can charge performance fees) is too painful.

Compared with these horrors, the regulatory clampdown on shorting financial stocks and the Lehman debacle are less scary. Big users of shorting usually do so as part of a strategy to reduce overall market risk. They can shift to shorting other sectors. And it is hard to see the potential for writedowns on collateral parked with Lehman amounting to more than 1 per cent or so of total industry net asset values. For this relief, much thanks.

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