

Hard times for hedge funds

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"I have come through '68, '72, '86, '87, '98 and 2002. But this is the worst ... It is batten-down-the-hatches time." Not the words of a fearful banker, but of a hedge fund manager. As markets plunge one day and rally the next, hedge funds have made headlines and been the butt of public anger by profiting from bets that share prices will fall. But, for many hedge fund managers, 2008 has been a disaster. An industry that has benefited from cheap credit, and which is shrouded in inexplicable mystique, is on the brink of a Darwinian shake-out.

There is no small irony in the fact that hedge funds, long feared to be a source of financial instability, are not the root cause of the current crisis. It was the regulated banks, not the hedge funds, that blew up.

Yet the industry's contraction is inevitable. It will be painful and could even have undesirable economic repercussions. However, as long as governments refrain from imposing heavy-handed regulation on the survivors, they should emerge in strong shape.

Until last summer, hedge fund managers had prospered by using money borrowed from banks and secured against shareholder funds to amplify the returns they made on their investment decisions.

The freeze in global credit markets and a generalised flight from risk brought an end to the boom. According to one measure, the HFRX daily index, the industry is down nearly 10 per cent this year.

This is less than the amount world stock markets have fallen. But for funds that are supposed to deliver steady returns above those that can be earned by holding cash, this is a shocking performance.

The main reason for the losses is that many funds' trading strategies have come unstuck in a "dash for cash". Among the worst hit funds are those that engage in convertible bond arbitrage and activist funds, which try to shake up the companies in which they hold stakes.

Other factors have added to the funds' woes. As their losses build, some funds become forced sellers to meet margin calls on loss-making positions. Investment banks that provide financing have retrenched, been taken over or collapsed.

Leverage has become harder to get, making it difficult for hedge funds to generate outsize returns. Regulatory bans on the short-selling of financial stocks have not helped because they have removed an important hedging tool. The demise of [Lehman Brothers](#) swallowed the collateral of funds that used it as a prime broker, adding to the strain. Some clients now want to get out.

For now, the rate of new fund launches is still running ahead of closures. That will not last. Funds that relied primarily on the practice of capturing credit risk and leveraging it have already gone to the wall.

The impending shake-out in the rest of the industry is overdue. There are simply too many hedge funds for their own good. Their growth was a luxury financed by unsustainably cheap borrowing. The industry's fee structure, where many funds charge a 20 per cent "performance" fee as normal practice, may come under greater client scrutiny. If the contraction removes second rate managers, so much the better. Only the most adaptable deserve to survive.

There may be few reasons to be cheerful right now, but the way in which the industry has started to contract is one. So far, those hedge funds that have closed – 350 in the first half of this year, compared with 563 for 2007 as a whole – have mostly done so without imploding spectacularly, along the lines of Long Term Capital Management a decade ago.

However, the industry's shrinkage does pose dangers. First, the loss of quantitative hedge

funds, which provide a large chunk of stock market liquidity, could add to the volatility in markets. Second, many hedge funds act as venture capitalists, providing small companies with funding they might not otherwise be able to access. Several of the biggest and most successful funds are also playing important roles in recapitalising the shattered banking sector. Barclays, the UK bank, relied heavily on hedge funds in a recent capital raising.

Regulators, therefore, must tread carefully as they draw up new rules in the wake of the credit squeeze and should target the causes of the crisis rather than hedge funds.

For the funds have helped make markets more efficient and offer innovative ways of raising capital. It is important, for example, that bans on short selling in the US and UK are short-lived. There is little evidence the bans have helped shore up bank share prices. The best result would be a more chastened hedge fund sector, unencumbered by heavy-handed controls.

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