

Panic in the hedgerows

Custom House's Dermot Butler casts a wary eye on the future of the hedge fund industry

One of the best rules I was taught by my parents was "Don't believe everything you read in the papers" and, without wishing to



sound too cynical, I suggest that should be in every school's curriculum.

Gone are the days when hedge funds were the super-risky plaything of the super-rich. Today, hedge funds are almost

mainstream – certainly, long short equity is mainstream, as demonstrated by the growth in 130/30 funds. They are no longer the investment of choice of the high net worth investor to the exclusion of all others. We have, over the past ten years or so, seen an exponential growth of investment by institutional investors into hedge funds, largely encouraged by Harvard, Yale and Calpers. I would also suggest that growth in hedge funds benefitted from the bursting of the 'tech' bubble in 2000/2001, when we saw some stocks fall by 60% versus a positive performance of most hedge funds.

And why or how did real hedge funds, not just survive, but actually make real returns?

They were able to do this because, notwithstanding that many hedge funds today invest in a variety of strategies and a wide range of derivative instruments, they are, for the most part, based on the original Arthur W Jones concept, which was very simple: Buy what you believed would outperform; and sell (short) what you believe would underperform.

If you were right in these two assessments, this strategy would generate profits with very little risk, albeit those profits would be less than you would have made by going long in a Bull market or short in a Bear market, but then, of course, by doing that, you simultaneously increase the risk. So AWJ maintained his long short low risk strategy and increased

the profit potential by using leverage – i.e. borrowing to increase the long and the short positions.

The fourth rule was "Don't disclose your portfolio, so you are not squeezed" and it is this transparency that seems to be one of the media's main bugbears.

It still astounds me how many financial journalists working for the tabloid and broadsheet newspapers seem to have been taught by their parents that "Hedge funds are inherently wicked and run by crooks and snake oil salesmen".

I had thought, or hoped, that the considerable efforts by the industry, largely led by my colleagues at AIMA, over the past two or three years would have gone some way towards ensuring that any "trial by the press" would be a fair trial. However, that proved to be a perfect example of the "triumph of hope over experience" as the press reaction to the alleged involvement of the world's hedge funds in the sub-prime debacle and the ensuing credit crunch has firmly put that optimistic approach to bed. The most encouraging comment in the press that I saw was, I am glad to say, from an Irishman – Mr. Charlie McCreavey, former Finance Minister in Dublin – who gave a fairly damning speech, in which he criticised SocGen's lack of controls with regard to the trading losses that should not have occurred. The encouraging part of his speech was at the end when he spoke about the irony of the demonising of sovereign wealth and hedge funds in the press, pointing out that, if it hadn't been for the sovereign wealth funds, at that time, several of the world's leading banks would have had severe capital problems and, if it hadn't been for hedge funds, then liquidity in the markets may well have dried up.

There have been a number of anti-hedge fund articles published in various newspapers, including two or three published in the Financial Times and the Daily Telegraph which were at best ignorant and, at worst, deliberately misrepresentative of the facts. The cynic in me leads me to believe that the press is more concerned in getting a juicy

headline and an exciting article damning someone and that concern takes full precedent over the truth.

I recently attended a conference in the Far East, which had a media panel consisting of representatives of the Financial Times, Bloomberg TV and, I believe, CBS Business News. They started their panel by saying that they were somewhat skeptical about the use of the name "hedge fund" because they were not convinced that everyone, or anyone, for that matter, knew what a "hedge fund" was and they didn't believe that many hedge funds actually hedged anything.

Someone in the audience introduced a story from a recent edition of the Wall Street Journal about a hedge fund manager. The headline was something like: "XYZ Hedge Fund Manager Achieves 22% Return In The Year To Date But....."

The story under this headline went on to explain that this particular manager had made a profit for the year by being short of various sectors of the fixed income market. It then went on to specifically refer to a long investment in a sub-prime or similar structured product, which had resulted in the portfolio suffering a loss in that investment of 2.4%, so his profit would have been 24.43% without that reckless investment.

The media representatives commented on this, but didn't seem to pick up the obvious point to me and so I asked them whether I was missing something, or was this not a perfect example of a hedge fund operating in just that way that they had, only a few minutes earlier, claimed hedge funds no longer behaved – that is the manager had hedged part of his portfolio. I went on to ask whether it was not obvious to everyone that, if you have a hedged portfolio, then one of either the long position or the short position will result in a loss. That is what hedging is all about.

My belief is that these stories and others that we have seen will encourage politicians, particularly German politicians, to attack hedge funds for all the old reasons. Having decided to attack them, they will then pass laws, again, in Germany and, therefore, perhaps in the EU, imposing unreasonable and unrealistic regulations on hedge funds. The optimist in me hopes that common sense will prevail, but that optimist has been proven wrong many times before.

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