

In Defence Of Hedge Funds

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We have all read a huge amount about evil hedge funds and the harm that they are causing the financial systems, with the implication that they were largely responsible for the current economic malaise, which is, frankly, nonsense, based either on ignorance or a mischievous intention to mislead.

The purpose of this article is to try and explain why I take that point of view and how I perceive hedge funds – as such, what I write is going to be fairly simplistic.

Historically, hedge funds were started after the war, surprisingly, by an enterprising journalist in the United States called Arthur Winslow Jones. I say “surprisingly” because, in the last twenty years, it has been almost impossible to find a journalist with a popular newspaper (as opposed to a member of the trade press) who understands hedge funds, let alone who is prepared to say a good word for them. Be that as it may, Mr. Jones structured a personal investing philosophy based on the fairly obvious strategy that you should buy stocks and shares that you believe will go up and you should sell stocks and shares that you believe will decline in value. Like any other investor, success will depend upon analytical capability. The advantage of a long-short position, such as this is that, if you are right about the stocks that go up, but the market declines as a whole, then the likelihood is that your short (bad company) shares will decline faster than your long (good company) shares. Similarly, if the market climbs, then your long shares should make more than your short shares lose. Thus, the long-short strategy removes a large portion of the risk of investing because it should, in normal market conditions, be profitable, regardless of the direction the market moves. However, the hedging component, which is designed to reduce risk, will also reduce the profitability and, therefore, you need to increase the size of the portfolio, in order to achieve decent profits. This can be done by leverage – i.e. borrowing money to enable you to both buy more good shares and sell more bad shares, and that borrowing is what is known as “leverage”.

It should be remembered that, one of the main objectives of a hedge fund is to produce what is called “Alpha” (the other main objective is to preserve capital and produce an absolute return – i.e. over and above the cost of money). Alpha is the return that a manager achieves over and above “Beta”. Beta is the basic return in the market – i.e. the S&P Index, if you are running a long short large cap US equity portfolio. This Alpha means that the fund will outperform the traditional long only funds and the hedging component should mean that, on bad days, the long short fund will achieve a profit anyway, albeit, perhaps a small one.

So what happened in 2008?

What a lot of people have overlooked is the fact that true hedge funds actually achieved Alpha in 2008 by as much as 15% or 20%. Some hedge funds lost money, but that was inevitable. There always will be somebody who makes the wrong analytical choice in the first place. Furthermore, because of the popularity of the term and the misapplication of the name “hedge funds”, there were many vehicles out there that were posing as hedge funds, but were, in reality, long only funds with a negligible short component.

Back to the point, many hedge funds achieved Alpha, which was half of their target, but few achieved absolute return, although not as few as the media might lead you to think. And so the question is “why did this happen?”

As I have explained above, one of the core components of a successful hedge fund is the ability to leverage the portfolio to reintroduce the profit element, which was diminished when the short hedging eliminated a large proportion of the risk element. In order to be leveraged, you have to have liquidity and be able to borrow money. The collapse of the banking industry, which was not the fault of hedge funds – meant that, even well run, low risk hedge funds, which had maintained a credit line with their banks for years, even decades, had that credit line withdrawn with little or no notice. As a result, those hedge funds had to liquidate their positions in order to pay off their borrowings. This resulted in a fire sale of both good and bad shares, all of which collapsed under aggressive selling.

As I have already indicated, the overall performance of properly managed hedge funds was, in fact, quite good on a relative basis, notwithstanding that many of them lost money. I was interested to hear that a leading pension fund consultant in the United Kingdom, when asked what pension funds’ attitude to hedge funds was in 2009 replied that:

1. Pension funds that were invested in hedge funds recognized that, notwithstanding the losses, hedge funds had achieved substantial Alpha and, as I have already said, the losses were the result of the unforeseen circumstance of total evaporation of liquidity. Therefore, these pension funds were inclined to look favorably on hedge funds, but would still probably have to sell or reduce the size of the hedge funds’ sub-portfolios. Ironically, this was because those funds had outperformed the rest of the portfolio and, therefore, were a disproportionately large component of that portfolio. The pension funds would have to sell their hedge funds in order to balance the overall portfolio and bring the hedge fund portion into line with their mandate. One can imagine that the pension fund managers might try and persuade the trustees to increase the hedge fund allocation, but that could, perhaps, be a difficult task if one of the trustees was the member of the Tanners Union in Ohio, who had only read bad, biased reports about hedge funds in the local press.

2. The second group of pension funds considered were those who had never invested in hedge funds and our consultant expressed the opinion that they looked upon them, perhaps even more favorably than pension funds that had experience of hedge funds. The consultant believed that those hedge funds were considering making an allocation into hedge funds and he expected those allocations could start surfacing in the third quarter, 2009.

This is, of course, all conjecture, but against that, the recent report on the 5th of March that a major pension fund had made the decision to allocate money to pension funds, was very encouraging.

I have previously written several times about Charlie McCreavy's comments concerning the demonization of sovereign wealth funds and hedge funds and we have all read too much about the misunderstanding of the political aversion to shorting, so I don't intend to add anything to arguments that have been expressed by others with much more vehemence than I could.

So what is going to happen? It would be a foolish man who would predict what's going to happen in the hedge funds market in 2009, except that it is likely that the politicians will manage to introduce new regulations. What is equally likely is that some of that regulation will be inappropriate and ill thought out. Whilst there are areas where regulation could be improved – presumably, that includes banking notwithstanding that banking is, perhaps, already the most regulated industry in the world - it would also appear that there is room for the better application of the regulations that exist.

Having said that, more stringent regulations on sales practices would be a good place to start. I suspect that, if there had been clear guidelines as to the liability of organizations that sold unsuitable investment vehicles throughout the United States and in the UK, where mortgage companies were able to sell mortgages for 100% or 125% of the value of the house to people who could not afford it or would not be able to afford it when the full charges came in, seems to be a glaringly obvious case of mis-selling. One recognises the obvious errors in the structure and management of the world's largest banking institutions existed. Nevertheless, this whole crisis was triggered by the collapse of the sub-prime mortgage market in the United States and, in the UK, appears to have been triggered by the collapse of Northern Rock. Neither of those can be laid at the foot of hedge funds, because, except for a few very smart short sellers, hedge funds were not involved, except, perhaps, as purchasers of some of the pooled sub-prime investment products sold by banks on behalf of the mortgage lenders. There is obviously a lack of due diligence there but, again, a first class rating from one of the leading rating agencies can, perhaps, dull the mind to other risks.

On the whole, I think that if regulation of hedge funds is to be brought in, then it should be targeted at the hedge fund managers, including CTAs and, perhaps, at some of the service providers, including fund administrators like ourselves, as well as, obviously, prime brokers. Indeed, are accountants not too protected in this regard? The funds, themselves, are relatively amorphous or intangible entities, usually employing no staff, except for the Board of Directors, or the General Partner, if it's a partnership. The directors have their responsibilities, but they delegate the function of running the hedge fund to the service providers and the investment manager.

For years, the regulation of investment managers in Europe has proved satisfactory and, again, I would say that, apart from some obvious and well-documented frauds, the regulation of hedge fund managers in Europe has been largely successful. In the US, they don't even regulate the manager, although I would expect that will come in soon. Furthermore, they don't require independent administration, although major European investors are now insisting on that and it is possible, if not probable, that the US will also endorse that by regulation within the near future. The suggestion that Bernie Madoff's fraud highlights the high risk of hedge funds is, of course, patently ridiculous, because, as I understand it, Bernie Madoff did not have a hedge fund. He was an advisor who ran managed accounts on behalf of funds and, as such, he should have been regulated and there, there may have been a failure by the regulators.

Furthermore, it may be that pressure will come to impose an independent administrator on managed accounts. Certainly there is a growing trend towards managed accounts – which suits administrators (like my own firm) who specialize in daily NAVs. With regard to Madoff, it would also appear that some of the feeder funds were guilty of a lack of due diligence and that, I suggest, was the fault of the managers of those feeder funds, not the fault of the fund itself. It must be remembered in all of this current hysteria that, when it comes to a dedicated crook, no regulation is going to stop them. It's not like an athlete taking an over-the-counter drug and not being aware that he's breaking the rules – a money manager or, indeed, a hedge fund manager who sets out to defraud their customers, whether it is by running a Ponzi scheme, or whether it is by allocating monies to purchasing Ferraris and a golf club (the entity, not the tool!) for their personal use. They know they are breaking the law and they are doing it regardless of the regulations in place. Stopping them will merely enable the authorities to incarcerate them – although that often appears to be extremely difficult – God knows why.

It also must be remembered that 99% of all those involved in financial services, including hedge fund managers, are honest and do a good job – but good news doesn't sell newspaper.

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