

The hedge is greener?

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By Kelly Durkin

The liquidity crisis has spread its tentacles to many sectors of the financial services industry, and hedge funds appear to be no exception, as dismal results pour in from a number of indexes tracking the investment vehicles. But despite the carnage, the almost \$2 trillion industry may not be down for the count, as the nature of the industry itself may prove to be the best protection in a crumbling and uncertain market.

Indexes across the board are down, with the Credit Suisse-Tremont Hedge Fund Index sliding 6.55% in September, after falling 2.61% and 1.27% in July and August, respectively. Hedge Fund Research's Weighted Composite Index is down 4.85% year-to-date as of Sept. 18, and fund-of-funds have also not been spared, with the Hedge Fund Research Fund of Funds Composite Index down 6.35% year-to-date as of Sept. 18.

Morningstar Inc. released its third-quarter hedge fund performance data on Oct. 14, revealing similarly negative results. Funds reported the "worst losses" in the history of the Morningstar Hedge Fund Index, and in September alone, the Morningstar 1000 Hedge Fund Index fell 7.87%, doubling August's losses. Year-to-date performance was also negative, with the index having dropped 13.17% over the third quarter.

Morningstar hedge fund analyst Nadia Van Dalen told SNL that she saw losses in almost every hedge fund category in September. "What happened in September was largely a macroeconomic event, not really based on the fundamentals of particular stocks or particular credits, but more on equities in general and credits in general, stemming from the credit crunch," she said. "No market is immune to it, and that's evident from this month with all of the central banks injecting liquidity into the system in concert all around the globe."

In light of the decline, hedge funds are also facing redemptions, forcing some to freeze assets and others to shut down completely. According to Hedge Fund Research, the ratio of estimated number of fund launches to liquidations in the first two quarters of 2008 has decreased substantially from prior years. As of Sept. 18, 487 new hedge funds had been launched, and 350 had been liquidated, compared to 1,152 startup funds and 563 liquidations in the full previous year.

Van Dalen said she expects more assets to leave the industry before confidence is restored. "I expect investors to wake up and realize hedge funds are not all they purport to be," she said. "Investors are not just going to assume just because it's a hedge fund its going to make them money."

Since many hedge funds have 45-day or 65-day redemption windows, if investors wanted their funds by the end of the third quarter, they had to notify the hedge fund of withdrawals by August or even July. With the deadline for December redemptions ending Sept. 30, the effect of these redemptions could have drastic effects

on the stock market if hedge fund managers are forced to sell large amounts of stock to meet the redemption demands.

But Richard Wilson, founder of the Hedge Fund Group and author of HedgeFundBlogger.com, told SNL that the lasting result may not be as dire as feared. "Many people are predicting the end of the hedge fund industry, and I think it's far from that, but it's obviously not the best environment for raising capital or even sustaining capital," he said.

With more than 10,000 funds located in countries around the world, investing in different securities and commodities, the industrywide risk is safely spread. On top of that diversification, managers have options with more than 100 unique strategies at their disposal and thousands of variations on those strategies. "Even if there is a massive meltdown," Wilson said, "I think that hedge funds will be around longer than banks, and banks will always be around."

However, on top of such turmoil, increasing regulatory pressure is lifting the curtain on these once secretive funds, exposing their strategies in the name of transparency, as the SEC investigates alleged market manipulation by broker/dealers. The SEC impeded upon one of the industry's premier strategies — hedging — when it banned the short sale of certain financial stocks in September. Then on Sept. 22, the regulators forced more than two dozen hedge funds to begin disclosing trading information as part of the SEC's investigation into possible market manipulation by traders.

David Friedland, president of the Hedge Fund Association, a not-for-profit collective of industry professionals, said in a statement that although funds "have clearly been impacted by the rapid changes to the shorting rules, and some funds will not survive," the organization "does not currently believe the impact to the hedge fund industry will be as grave as many predict," because of the sector's "ability to innovate" in times of crisis.

Such scrutiny of funds' recent trading actions, including short selling, will "most definitely" continue, especially in light of recent bank failures, said Amy Lynch, president of consulting firm FrontLine Compliance LLC.

"It was deregulation that helped get us into this mess," Lynch told SNL. "The whole mortgage industry was rather an unregulated market, and that's really what brought us into where we are right now. I think they're going to increase regulation on the banking side and find a way to increase transparency around the [mortgage-backed securities] market so that it won't be as easy the next time around for banks to get overleveraged like they did this time."

In his statement, Friedland said he "has never been opposed to reasonable regulatory oversight, provided that these regulations are not unduly burdensome" and specific to only hedge funds.

"We ... believe that any regulatory framework should not single out hedge funds, but should include all market participants," he said. "As the recent banking crisis demonstrates, regulated entities can have a greater impact to market stability than hedge funds." *i*