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## In the wake of the global financial crisis, Fortune CIO, **Nancy Curtin** discusses the future for hedge funds

In September and early October, the financial world, as we know it, turned upside down. The shakeout in the financial services industry around the globe – particularly in the US and Europe – caused markets to behave unpredictably with extreme volatility.

Amidst these unprecedented events, even some of the best hedge funds managers have found positive returns elusive. Of greater concern to our investors however are the reports of impending hedge fund closures and liquidations – the magnitude of which are uncertain – although industry commentators have speculated that as much as \$300bn in capital might be removed from the industry. While this number sounds large, it needs to be put in the context of the near \$500bn that has been redeemed from mutual funds globally. We also believe that this number is likely to be overstated.

Many industry reports have queried whether this asset class is permanently impaired. We believe strongly that this is not the case. Clearly those hedge funds that have performed poorly, used excessive leverage, ‘passed beta off as alpha’ or did not have a disciplined risk management approach face an uncertain future. It should be noted, however, that while hedge fund performance has been disappointing from an absolute return perspective and while certain hedge funds may struggle to return capital in freefalling markets – resorting to gates and side pockets – no hedge fund to date has employed the types of excessive leverage utilized by the financial sector. What is dead is the investment banking and banking model with leverage up to 40-60 times using only ‘others people’s money’. We continue to believe **there will always be demand for talented managers who can deliver strong alpha based risk adjusted returns using either their superior investment (long and short) or trading skills, particularly the ones whose personal capital is also at risk.**

In this note, we seek to address a few key points regarding the current crisis and its potential effects on the future of the hedge fund industry.

### SEPTEMBER IN FOCUS

Equity markets declined about 11% during September while hedge funds – despite entering the month with low exposure levels – declined about 7-9% on average depending upon strategy. The fund of funds index was down 6% in September, its second worst fall since inception in 1990 (the index was down 7.4% in August 1998).

Although year to date performance has not met with investor’s desires for positive returns, we would argue that a range of factors that were both unforeseeable and difficult to manoeuvre around such as excessive volatility, deleveraging ahead of feared redemptions and unprecedented movement of assets across counterparties go a long way towards explaining underperformance in Q3. Further a decline of 10%, year to date at the end of September, for hedge funds should be seen in the context of global markets which have fallen by 25% to 30%. Moreover, in October with markets down 40% to 50% year to date, a diversified portfolio of hedge funds is down 12-15% YTD (including our worst ‘guesstimate’ of performance to October 10th), which while hardly inspiring is nonetheless attractive by comparison.

As investors reflect upon hedge fund performance in 2008, they may feel that comparatively hedge funds have not fared so poorly, particularly after what, in hindsight, can be viewed as rather supernormal gains last year; in 2007, most of Fortune’s hedge fund portfolios were up 15% on average. Taken together, over 2007 and 2008, to end September, Fortune’s hedge fund portfolios are up approximately 5% versus a decline of 21% for global markets over this period.



skills and infrastructural quality. While the largest manager controls only about 2% of the industry, the top 100 hedge funds manage about 75% of industry wide assets, meaning that there is a large number ('tail') of small and medium sized hedge fund firms. We believe that the current turmoil will question the survival of many smaller players with poor infrastructure, low levels of financial stability and weak risk management and oversight. Managers who simply 'dressed up beta as alpha' and those who utilised excessive leverage to deliver returns will also be tested and may cease to exist. Other funds likely to close down include those that:

- cannot satisfy redemptions due to liquidity mismatch
- performed extremely poorly in 2008 and, having now lost investor confidence, are experiencing large redemptions
- imposed gates, used side pockets and 'changed the terms of business' with investors

We believe that the future will favour larger, institutional quality players with the depth of infrastructure to support a disciplined risk management framework at both the operational and the portfolio levels – factors which Fortune had been stressing since its inception. A further positive of industry consolidation is that fewer players will be exploiting market inefficiencies, leaving a less crowded marketplace for the survivors. In addition, investment opportunities are tempting some previously 'hard closed' funds to re-open, providing excellent opportunities to access excellent investment talent in this period of extreme market dislocation.

#### **Fewer Strategies**

The continuous boom period of 2002-07 gave rise to many strategies which profited solely based upon models that assumed predictable spreads and/or constant volatility; these strategies will die a natural death. Further, many esoteric structured finance and lending strategies will also fall out of favour. The effective demise of the above strategies may also take the shine off many multi-strategy funds that aim to deliver better risk-adjusted returns by diversifying capital into a wide range of - in some cases - quite arcane and less liquid strategies.

## **FUTURE OF THE HEDGE FUND INDUSTRY**

Fortune believes that the current market crisis and likely large redemptions from this asset class will lead to changes in the nature and structure of the hedge fund industry. There are six areas of change which we examine below:

- Fewer players
- Fewer strategies
- Less leverage
- Different counterparties
- Increased regulation

#### **Fewer players**

Over 80% of hedge fund managers are below their high water mark and there are estimates that up to 20% of the industry could be forced to shut down. As mentioned, while we believe that this number is likely overstated, it is clear that some players will cease to exist. We are monitoring all of our funds and will of course look to redeem any managers perceived as being at risk.

However, the decline of many funds must be viewed in the context of industry dynamics. Hedge funds are a highly fragmented industry with many different strategies and almost 10,000 players of highly varying investment

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As the present turmoil delivers its verdict on many strategies, we expect the current 'plethora of hedge fund strategies' to simplify into two primary categories:

**1 Fundamental (either Equity or Debt, e.g. Distressed) with a disciplined hedge**

The fundamental category or 'Long-term Alpha' includes strategies that exploit mis-pricings and market dislocations in order to deliver an absolute return over a longer term investment horizon. As the level of risk in the system was grossly underestimated by all market participants, many fundamental funds did not deliver a positive return YTD. We think that managers in this category, who operate with a disciplined hedge strategy, have a long track record, use little leverage and have their own capital at risk alongside investors will survive. After this crisis, these funds may need to realign their liquidity terms with their investment horizon and should seek to deliver less correlated absolute returns – at least on the downside.

**2 Traders (Macro/Systematic/Trading Strategies)**

The traders or 'Liquid Alpha' category includes short/medium term trading strategies that exploit volatility, macro trends, and patterns either through extensive manager trading experience or systematic strategies. Many such funds have done exceptionally well in the current period of amplified volatility and are in positive territory this year. These funds do not use excessive leverage (in the sense of borrowing, typically investing in leveraged products on margin) and can provide un-correlated returns. The level of liquidity and transparency typically offered by such funds is highly attractive and access can occur directly through funds or through managed accounts. We believe that managed accounts may well become a more important part of the investment landscape particularly for these more liquid strategies.

**Less Leverage**

In a world with unprecedented levels of government borrowing, we must assume that the government will squeeze out the private sector and that capital will be constrained. This should lead to an increasingly low leverage, risk-averse environment in the future. The current 'deleveraging' will further reduce the amount of risk capital available in the market thus rendering every

kind of borrowing more expensive with real rates of interest likely to rise and borrowing spreads becoming more costly.

However, it is inconceivable in Fortune's view to imagine that investors will not be able to margin stock portfolios. While 'nationalised government banks' may be forced to focus solely on lending to businesses and consumers, for the remaining strong banks and brokerage firms stock margin is a significantly low risk and profitable business because lending is done against a fully collateralised portfolio that can be liquidated in a few days, unlike a house or other illiquid asset. However, in relation to shorting, investors should also consider the following:

**Regulations on shorting and disclosure**

Shorting prohibitions were removed last week in the United States. It was realised that the shorting ban may have actually exacerbated the downdraft felt by financial shares since many investors chose to liquidate their positions as hedging became more complex with added basis risks. However, under extreme regulatory uncertainty, shorting bans could be applied again. Far more likely and helpful for the industry is that naked short selling and 'predatory shorting practices' will be disallowed. The SEC, in addition, is expected to publish a ruling on whether current required disclosure of shorts will be made public. Many of our managers believe that public disclosure of shorts is not in the interest of smoothly functioning markets. Fortune will continue to monitor this situation as it develops.

**Cost of borrowing stocks for shorting**

We anticipate that there will be fewer and perhaps larger brokerage firms going forward and that stock lending may occur on more stringent terms. Potentially, fewer traditional long only firm will engage in stock lending. Re-hypothecation – in which brokers loan the same stock many times over – will decline. A decreasing volume of stocks available for borrowing could both render the borrowing of stocks more expensive and limit the scalability of many strategies that rely on shorting. That said, Fortune has spoken to many players in the 'stock lending' business and, at least on the mutual fund side, stock lending is viewed as a low risk method of return enhancement. To date, our managers

have not faced any issues in identifying a borrow for their shorts.

Though some factors such as increased borrowing costs and more expensive stock borrowing could imply reduced hedge funds returns, we believe that talented managers will find 'less capital overall chasing more market inefficiencies' to be far more 'return enhancing' than the likely slightly higher cost associated with leverage or stock borrow.

### Different Counterparties

The counterparty landscape in which Goldman Sachs, Morgan Stanley, and Bear Stearns once dominated the prime brokerage business with approximately 60% market share is likely to be redrawn. As investment banks change their structure to become bank holding companies and/or re-integrate with commercial banks, they will be forced to reduce leverage and undergo increased regulatory scrutiny. The future will likely favor the 'strong financial few' such as JP Morgan, Deutsche Bank, Citigroup, Bank of America and BNP. We are also seeing new entrants such as Fidelity Prime Brokerage, who report being 'busier than ever.' All players are likely to experience increased regulatory oversight, which is no bad thing.

The above changes notwithstanding, we believe that the real balance of power in the counterparty world will shift towards managers. Our discussions with a range of large established managers have indicated a determination to 'never put themselves or their investors in this position' again. Large hedge funds will demand better terms for themselves in brokerage and other financing agreements – particularly regarding safety and segregation of assets and cash, and transparency on re-hypothecation. This is a huge positive for the industry.

### Increased Regulation

It is all but certain that the hedge fund industry will become more regulated than before. Fortune views increased regulation as a positive for investors because improved accountability and transparency will force better internal controls within hedge funds across the industry and foster the spread of "best business practices" and institutional quality back office and operations. We think it is important that industry participants engage with regulators to ensure that regulation is meaningful and appropriate for this asset class. Already some hedge funds

including the Tiger Cubs are actively engaging with the SEC about regulation, for example disallowing naked or predatory shorting.

Markets too will be subjected to further regulation, specifically in some OTC (over the counter) markets. Regulations regarding establishment of exchanges for CDS (credit default swaps), such as the proposed 'CME-Citadel' CDS clearing exchange, and removal of uncertainty about counterparties are beneficial for all in the industry. In general, we view any regulation that increases transparency, and efficiency of trading in the markets as nothing but beneficial.

### FINAL THOUGHTS

We believe that recent extreme events coupled with lackluster performance from many hedge funds will have a significant effect on the hedge fund industry and may lead to some important structural and positive changes. The crisis will likely serve to reduce complexity of the industry and remove some players that are either too weak financially and/or infrastructurally or are not true hedge funds 'in the first place.'

Nonetheless, talented managers who can deliver strong alpha based risk adjusted returns will survive and likely thrive in a future environment where fewer players will be chasing more opportunities and market inefficiencies. Another positive is that the opportunities generated by this period of extreme market dislocation have incentivized some previously "hard closed" funds with outstanding track records to re-open to investors. Further, if we enter an environment where investment returns are challenged, we are likely to see some pressure on the standard fee structure of 2% and 20%, however to date we have seen no evidence of this pressure upon high quality managers.

At present, we see enormous market distortions and price dislocations. Many asset classes are representing the best value opportunities in the last 10-20 years. Opportunities in the distressed space and the short side are likely to be abundant once the recession takes hold. Our anecdotal evidence suggests that while many FOF groups are redeeming, long term investors such as endowments and family offices have chosen to 'stay the course' with their hedge fund allocations in what is likely to be a 'once in a lifetime' investment landscape as markets renormalize.

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