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# Hedge Funds - Risky Business

Smart Investing Conference Call

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# Overview of the Recent Market Volatility

- The recent implosion of the subprime mortgage sector has sparked a wide scale liquidity-driven sell off in the financial markets
  - Deleveraging by hedge funds is the primary culprit
- While corporate credit has tightened, there has been no significant increase in defaults
- Bottom line – while problems with subprime mortgages have sparked an increase in market volatility, the size of the overall problem is modest compared to past financial shocks
- The market was not overvalued going into the downturn and the global economy was strong
  - Recent losses therefore should be short-lived
- Volatility had been abnormally low over the 2003-2006 period so a return to this environment is unlikely
- The Economist magazine recently opined it “was a good time for a credit squeeze”,
  - Lending standards have been too loose
  - The global economy is strong enough to handle a tightening now
  - If poor lending standards were continued, greater excesses and worse contractions would result

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# 2007 – Shades of 1998?

| | Fundamental Event | Funds that held these securities also had to sell: | Casualties (i.e the most leveraged players) |
|---|---|---|---|
| **1998** | Russian Default | Their most liquid risky debt:<br>- Junk Bonds<br>- Emerging Market Bonds | Long Term Capital Management<br>- Held no Russian Bonds |
| **2007** | Implosion of Subprime Mortgages | Securitized Bank Loans<br>(also suffered from a stop in CLO activity)<br>Unlevered mutual funds lost 3-4% in July | Sowood (-60%)<br>- 10-12x Leveraged exposure to securitized bank loans<br>- hedged by shorting subordinated debt and equity<br>- spreads on loans widened more than that on junior bonds. |
| | | Stocks<br>- Largely market neutral quant strategies<br>- Significant crossholdings among funds in this category due to similarities in their models<br>- Often 5-6X leverage or more used | *Leveraged Market Neutral Equity / Stat Arb*<br>Goldman Sacks Global Alpha (-26% YTD)<br>Renaissance Medallion (-8% MTD)<br>TYHKE Capital (-17 to -31%) for August<br>AQR (-13% MTD)<br>Highbridge, DE Shaw & Caxton - unspecified losses<br><br>Per Financial Times, the average quant fund was 4X levered and down 15% month to date |

- Distress in the subprime mortgage sector sparked liquidations by hedge funds of stocks and other readily liquid investments
- Quant funds were the most severely effected due to leverage of 4-10X
- Goldman Sach's computer model indicated occurrence in July would happen once every 100,000 years
  - Perhaps the model was wrong?

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# Problems with Statistical Models

- Most quantitative models rely on estimates of standard deviations from past behavior and assumptions of normally distributed returns
  - Both assumptions are faulty
- Volatility in the markets is not a constant
  - There are no guarantees that volatility in the future will be comparable to volatility observed in the past
- Returns on stocks and bonds are not normally distributed
  - They have fat "tails" – meaning that losses often exceed what statistical models would predict
  - For example, based on estimates derived from observable market data available at the time, the October 1987 crash was a more than "once in the age of the universe" event
- It is somewhat surprising that well-trained professionals still use phrases like a "1 in 100,000 year event" when this fat-tail phenomenon is well documented in economic literature
- Unlevered investors can withstand the "1 in 100,000 year events" that happen every few years, but leveraged investors will often be wiped out

# Differences between 1998 and 2007

- Total Hedge Fund assets in 1998 were around $400 billion whereas today they are over $2 trillion
- Long Term Capital had a large concentration – estimated at $129 billion of assets against less than $5 billion of equity
  - Long Term Capitals assets were nearly 1/3 of the total equity of the industry
  - No other players were well capitalized enough to take advantage of LTCM's distress
  - No player today has this concentration of assets nor this amount of leverage available to them
- In 2006 and 2007 Citadel Investment Group, with a capital base of over $15 billion, was able to acquire the assets of Amaranth and Sowood at substantial discounts after their implosions
  - In both cases this contained potential further market disruption
- Today's larger hedge fund industry likely translates to more frequent, but less severe liquidity crunches than what was experienced in the 1990's
- Greater risk may come from competition for profitable trades
- Low volatility periods can create higher risk by encouraging leverage to reach acceptable returns

# Issues with Hedge Funds in General

- At a 13% gross return, a 2% management fee combined with 20% of the performance nets 8.8%
  - The manager gets 4.2%, roughly 1/3 of the return
- Assume an investor can earn 5% without risk (say in T-bills)

The basic question:

In a competitive global financial market are there really investment strategies that can absorb these fees and deliver excess returns above risk free rates (i.e. alpha) without assuming other forms of risk (i.e. beta) –AND- have capacity in excess of $2 trillion US?

- The answer is obviously no, so where do Hedge Fund returns come from?
- There is a fair amount of research in replicating hedge fund return patterns with passive strategies involving exposure to multiple risk sources
- Research has used risk factors such as:
  - The difference in returns between small and large cap stocks
  - The relative performance of the dollar to other currencies
  - Credit spreads
- The studies suggest that hedge funds do provide exposure to a complex combinations of risks that are not picked up by simple benchmark comparisons, therefore they show up as “alpha”

# Opportunities do Exist

- The instutionalization of the industry and dominance of the mega-funds will likely squeeze out many mid-size funds that lack the asset base and sponsorship of the large funds
- Opportunities exist for smaller players focusing on capacity-constrained trading ideas
- The hedge fund compensation structure works for a small pool of capital ($50-250 million) organized around finding under-followed, capacity-constrained opportunities

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