Down BUT Not Out

Among hedge funds, secure and steady suddenly sounds spectacular

By Gregory Morris

HEDGE FUND MANAGERS have been surprised by how quickly their markets fell off the table. As recently as August, most managers were managing the downdrafts and unwinding positions without panic. Then came the battle over the federal rescue package, the Securities & Exchange Commission's suspension of short selling for select financial stocks and huge swings in major equity indices.

Still, hedge fund data through September show it was not as bad as most people thought. The HFN Hedge Fund Aggregate Average was down just 5.36% in September and down 8.76% percent through the first three quarters of the year. To be sure, that was a stark contrast to the 10.53% increase for the first three quarters of 2007, but hedge fund performance was just a fraction of the huge declines in equities.

Of course, overall averages only show so much. One thing that does leap out of the averages is that fund-of-funds underperformed the aggregate average for the month and year to date, as well as 2007 gains.

"To have fund-of-funds perform a little worse is disconcerting," said George Lucaci, senior managing director of Channel Capital Group. "The fund-of-funds approach was supposed to give us some cover, but they have been hit hard by redemptions and forced to sell at the worst possible time. Direct funds, in contrast, have had a little more time to arrange their redemptions. They also had gates up to control redemptions."

Lucaci acknowledged that tough times are likely to persist. "This is not over yet; it is still a battlefield out there," he said. But when the dust settles, he believes the hedge fund world will have been consolidated and therefore stronger. "It also will be more regulated, and that is a good thing. I don't think some regulation will hamper the creativity that has driven hedge fund success. If anything, greater transparency and limits on leverage will help."

Even if those and other reforms do not become official regulations, Lucaci said they are likely to become de facto business practices. Similarly, he believes ratings will be more rigorous. "Up until recently, ratings were based on historical performance," he added. "Now, they will have to be stress tested out to several standard deviations."

A Tale of Several Strategies

Picking over the rubble, Lucaci noted several differences in the fortunes of various strategies. "Emerging markets have done badly," he said. "One problem was that they had less capacity to contain the influx and outflows. Some funds in India returned 112% last year, but this year they are down 80%. It was unrealistic to expect that those markets could take in so much money."

Another hard-hit category is long/short equity. In that case, Lucaci suggested that the problem lay with the practitioners, rather than with the strategy. "There were a lot of pretenders in that category who were never really long and short," he said. "They were long bias and sometimes short. Those have really been wiped out."

Dave Friedland, president of Magnum U.S. Investments and president of the Hedge Fund Association, concurred. "The long-bias funds were really hurt when energy fell out of bed," he said. "Convertible bond arbitrage index funds also are in bad shape because they were prohibited from trading. In contrast, some shorts and macro funds were up. Asset-backed funds were up as well."

The ban on short selling rankles Friedland because regulators changed the rules in the middle of the game. "It wasn't just the SEC," he noted. "In the U.K. and Australia, there has been an outright ban. But if as a fund manager I knew that I would not be allowed to short, I would have done the long side differently. Banning shorts was prejudicial against hedge funds. And it did not work."

To be sure, Friedland is not opposed to regulation. "Bringing back the up-tick rule might make some sense," he noted. But until markets and regulators both start making more sense, he believes people will just stay on the sidelines. "They are shell-shocked. Cash is the only safe haven. There is a real flight to quality."

Friedland added that he is keeping an eye out for signs that stability is coming. One would be less volatility. "I'd like to see an end to 500-point swings up and down in the Dow," he said.

"Another tell-tale sign will be when companies' stocks start reacting to their own news, as opposed to sector or market news. When you see 29 of the 30 stocks on the Dow all down on the same day, that's just dumping."

The flight to quality and cash may prove useful in the end. "Those hedge fund managers on the sidelines today will come in to scoop up bargains, unless they are hit with big redemptions," Friedland said. "When the forced selling stops, managers can start to get back in."

Lucaci agreed. "We will have a smaller and simpler hedge fund world, but these strategies are not going away," he said. "Emerging markets are not going to disappear. Energy will come back."

Diversifying Beyond Funds

In the ultimate hedge, some of the largest managers are actively developing other aspects of their operations, diversifying their business model even as they plan their core hedge strategies for next year. Citadel Investment Group, based in Chicago, is a prime example. In the space of just two weeks in October, Citadel formed two opportunistic joint ventures and cherry-picked a top Merrill Lynch executive to grow its capital markets business.

Citadel declined to comment specifically on its hedge fund performance, even though some strategies, including equities, have done relatively well by outside measures. Indeed, the company is known to be planning a single-strategy fund in that area next year. Other single-strategy ideas under consideration include macro, convertible bonds and even mortgages.

Meanwhile, Citadel and the Chicago Mercantile Exchange announced plans to create what it says will be the first electronic trading platform that is fully integrated with a central counterparty clearing facility for credit default swaps. CME Clearing, which claims primacy as the world's largest derivatives clearing house, will be the central counterparty.

The venture, to be called CMDX, will operate independently with its own board and management team. As much as 30% equity is being offered to major CDS players. Sources familiar with the project said the technology was in place and that the platform had been built out.

"It is imperative to bring stability and transparency to the CDS market," said Ken Griffin, CEO and founder of Citadel. "This venture addresses today's immediate concerns and provides tremendous opportunity for market users into the future."

Separately, Citadel and the Macquarie Group, Australia's largest securities firm, have formed a joint venture in New York to insure municipal and infrastructure debt. Having received a license in New York State, Municipal & Infrastructure Assurance Corp. (MIAC) was reported to be seeking a triple-A rating. Once that was secure, it expected to seek licenses in other state.

The partners intend MIAC will close the market gap that opened when the incumbent large bond insurers lost their top credit ratings. To that end, the venture will not insure securities backed by subprime mortgages or other debt that caused the downfall of MBIA and Ambac. Macquarie and Citadel will jointly own about half of MIAC with several institutional investors owning the remainder. At press time there had not yet been any formal investments in either MIAC or CMDX, but interest was known to be keen.

Most recently, Citadel hired Rohit D'Souza, late of Merrill Lynch, to boost its growing capital markets presence. D'Souza was global head of equities and alternative investments at Merrill, responsible for all trading and sales trading activities for cash equities, equity-linked products, strategic trading and all of the global equity financing and services businesses.

"Rohit is an innovator and business builder who takes a collaborative and forward-thinking approach to creating broad market opportunities," said Griffin. "His track record of leading diverse, client-facing businesses puts us in a very strong position to evolve and grow this important platform over the near and long term."

Citadel's capital markets businesses execute and route more than 30% of average U.S. listed equity options trading volume and more than 8% of average Nasdaq and NYSE equities volume. The platform also includes Citadel Solutions, a hedge-fund administration business begun last year that serves hedge funds with a total of more than $30 billion in assets under administration.

Slow and Steady Wins

As with Citadel, several other large hedge funds declined to comment on current conditions. But when a storm blows down the tallest trees in the forest, the smaller ones suddenly get more sun. Specialized funds that once were plugging along with regular but unremarkable performance are now getting new attention in the flight to quality.

White Oak Partners* of San Francisco, for example, aims to return 1% per month. With some investments losing double-digit percentages in a day, that now does not seem so dowdy. White Oak also has the moral high ground of being part of the solution: It is a strict asset-backed lender that demands high-quality collateral.

"We are doing what banks were doing for the past 100 years but got away from," said Andre Hakkak, managing partner. "We are hard asset-backed lenders. We prefer collateral we can

touch, as opposed to something like receivables." With CIT, Allied and GE Capital struggling and local banks hoarding deposits, White Oak fills a void in the market. It protects itself and its investors with the quaint notions of due diligence and lending against the discounted value of hard assets.

"A big part of the problem in the credit markets today is that even good companies cannot get credit," Hakkak said. "A guy with a great business, excellent assets and strong macros to the economy goes to his bank to renew his line of credit, and they won't give it to him. Not because he's not a good risk, but because they are 'de-levering.'"

In contrast to that, Hakkak noted that White Oak is an astute lender. "We are not in equity or mezzanine or second liens; we are in senior debt," he said. "If we don't get our money back, we get collateral. The only thing that keeps me awake at night is my newborn."

White Oak has $500 million in investment capital and has committed half of that to a hedge fund. The fund has a $3 million minimum investment and a one-year lock.

In pursuit of even higher quality investments, Hakkak said White Oak will soon open a sister fund or new class of investments with a longer lock. "I am so happy we have our capital by contract," he added, "that is the only way to survive today. Look at where managers are being forced to sell for redemptions."

Strategy Matters

Even doing everything properly is no guarantee of positive returns if the underlying strategy suffers. Tradewinds Investment* of Sausalito, Calif., manages several limited partnerships in emerging markets. "That sector has been beaten up more than just about anyone else," said Bob Scannell, general partner. "I view these last few months not as a test of management skill, but as a test of your model. If your approach was high leverage and low quality, you are out of business. Lots of models have been destroyed."

Tradewinds did just the opposite: no leverage and actively discouraged short-term and fund-of-fund investment, Scannell noted. As a result, his funds have done better than their benchmarks and have seen virtually no redemptions. "We also were very critical of who we do business with, so we have avoided counterparty risks," he added. Echoing other managers who noted that the suddenness of the current downturn was surprising, Scannell said this particular episode was tough to catch. "We were looking out from the U.S. to the rest of the world, so everything looked good until about half way through September."

When things went bad, Tradewinds moved to about 60% cash. Sitting on that nut means that Scannell is already looking at the market with a buyer's eye. "Markets are discounting to a global depression, and I just don't think that is going to happen," he said. "This crisis is all about credit, so once LIBOR rates are lower and the short-term debt market starts functioning again, there will be once-in-a-lifetime opportunities. A lot of studies show that the year after a crash usually offers about a 50% gain from the bottom."

Distance Equals Perspective

For the best perspective on what has transpired in hedge funds, it is necessary to step outside the market, but not too far out. Four years ago, Schroders Investment Management began operating a "multi-asset solution." It is regulated, so strictly speaking is not a true hedge fund. But it operates on a classic hedge fund model.

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"We are a macro hedge fund operator in a regulated space," said Andreas Koester, head of U.S. and European multi-asset solutions. "We also run some mandates in the non-regulated space and can invest 100% in alternative assets like hedge funds for some pension clients." The big London multi-asset house currently runs $7 billion of its $44 billion in AUM in the strategy.

In November 2007, Koester and his team started reducing their equity allocation from as much as 70% to about 20%. "We got a top-down signal but checked with our sector and asset-class teams, and they confirmed the move," he said. "The risks were either stagflation or a credit crunch. What no one anticipated is that both would happen, one after another. Monitoring correlations, we saw 10 asset classes shrinking to two: risky and cash. As diversification worked in stagflation but less so in the credit crunch, we had to inject more cash into the equation."

Looking ahead, Koester expects it will take three to four months for the actions of central banks to gain traction. "Then markets will focus back on the economic cycle," he said. "They will realize that we are in a recession, but that is okay because they understand what asset classes to focus on in a recession." As a longer-term strategy, Koester is a major proponent of infrastructure, accessed mostly through closed-end funds, direct investment and public-private partnerships. ii

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